No. 81817-7

SUPREME COURT OF THE STATE OF WASHINGTON

CERTIFICATION FROM
UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON AT SEATTLE
MASTER FILE NO. C06-0794 RSL

In re F5 NETWORKS, INC. DERIVATIVE ACTION LITIGATION

GLENN HUTTON, et al.,
Plaintiffs,

vs.

JOHN McADAM, et al.,
Defendants.

PLAINTIFFS' BRIEF ON CERTIFIED QUESTION

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I. INTRODUCTION

Invoking this state's certification procedure, the U.S. District Court for the Western District of Washington has posed the following two-part question to this Court:

> "What test does Washington apply to determine whether allegations made pursuant to RCW 23B.07.400(2) by a shareholder seeking to initiate derivative litigation on behalf of a Washington corporation excuse that shareholder from first making demand on the board of directors to bring that litigation on behalf of the corporation?; and
>
> If Washington follows Delaware's demand futility standard, does it also follow the reasoning of *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) in cases where the improper backdating of stock options has been alleged?"

Certification Order, p. 2 (Record No. 98).

Although the point gets lost in the opening brief of nominal defendant F5 Networks, Inc. ("F5"), derivative actions serve an important public interest function. Officers and directors of a public company are not free to do as they please. They are fiduciaries constrained by strict legal obligations to act in the best interests of the company and its stockholders at all times. Many of these managers do the job honorably, but the jarring corporate scandals of the past decade are a stark reminder that too many corporate insiders misplace their fiduciary compass. Forgetting they are stewards of other people's money, they abuse their positions of trust and authority to enrich themselves. When this occurs, and the board is disabled from acting due to its own involvement in the illegal conduct, the shareholders must step in to protect the company's rights. This premise for the derivative suit is time-tested and rock-solid. Although Washington should be an attractive place to incorporate, this coin has a flip side. It must also be a trustworthy place for citizens to invest. If anything, recent abuses reaffirm the basic need for stockholder access to the courts to hold corporate wrongdoers accountable. *See* Part III.A.

Indeed, on the scope of the presuit demand requirement, F5's arguments miss the mark. RCW 23B.07.400(2) provides for "demand futility," not "universal demand." Before the statute was enacted in 1989, moreover, Washington courts recognized that a presuit demand is excused when it would be futile or, as the earliest cases put it, useless. Washington statutory and decisional law points unequivocally to a demand futility standard. Even if universal demand could be called a trend – it is not even followed by a majority of states – it is unquestionably a legislative phenomenon, not a judicial one. The states that have adopted universal demand have overwhelmingly gone this route by statute. For a host of reasons, F5's request for a major change to universal demand should be presented to the Legislature, not this Court. *See* Part III.B.

Plaintiffs submit that the more serious issues here, on which the U.S. District Court really seeks guidance, concern to what extent Washington law on demand futility should be further developed by drawing on an extensive body of Delaware law. The Delaware judiciary is well versed in corporate law and its decisions are persuasive. In particular, the Delaware Supreme Court's test for assessing demand futility – stated in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) – is widely followed. When moving to dismiss this case in federal court, F5 itself cited *Aronson* as providing the controlling legal standard for excusing demand. To develop Washington law on demand futility, this Court too should follow *Aronson*. *See* Part III.C.

Likewise, decisions of the Delaware Court of Chancery, a specialty tribunal for business disputes, are also highly respected. The Chancery Court's *Ryan* opinion sets forth sound principles on pleading demand futility in the options backdating context, and therefore should also be followed here. *See* Part III.D.

II. STATEMENT OF THE CASE

A. Plaintiffs' Complaint Challenges an Elaborate Backdating Scheme at F5 Carried out to Enrich Its Top Officers and Directors

A stock option is the right to buy shares of a public company at a particular purchase price, known as the exercise or "strike" price. *See* Appendix in Support of Plaintiffs' Brief on Certified Question ("PA"):2. Public companies almost universally set the exercise price at the fair market value of the stock on the date the option is granted. PA:2. When the stock's trading price exceeds an option's exercise price, the option is "in the money" and valuable to the holder. If the trading price goes down after the grant date, however, the option is "under water" and worthless. PA:3. Approximately a decade ago, a new practice ensued in corporate boardrooms aimed at reducing this uncertainty and increasing option values. The practice was simple and yet difficult for government regulators or shareholders to detect. Corporate insiders in charge of issuing options selected – put more bluntly, falsified – the option grant date with the benefit of hindsight to coincide with a dip in the trading price. Akin to betting on a horse race after it is over, this is stock option "backdating." PA:3.

In March 2006, *The Wall Street Journal* published an article titled "The Perfect Payday." The investigative piece confirmed what many had long suspected – backdating was widespread in public companies. PA:84. A wave of shareholder lawsuits soon challenged this practice. The derivative complaint now before this Court, filed on behalf of F5 against its board members and certain top officers, is one such suit. Plaintiffs assert causes of action under the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002 and state common law (breach of fiduciary duty and related claims). PA:70-78. The complaint alleges, among many detailed allegations, that 12 of 26 stock option grants to F5's directors and top officers fell on the lowest or second-lowest monthly closing price for F5 stock in a given time frame.

PA:2. The odds of this occurring by chance are just 1 in 2,764,905. PA:2. Charts in the complaint graphically demonstrate how F5's board had an uncanny aptitude, too precise to be good guesswork or luck, to pick option grant dates at the bottom of the trough. PA:27-36. There was great pecuniary incentive to backdate. Defendants have realized over $161 million by exercising backdated options. PA:3.

The harm to F5 (of interest because this is a shareholder derivative case) from this outright greed has been substantial. PA:62-64. Because the exercise price for F5 insiders' stock acquisitions was artificially low due to backdating, money that should have gone into F5's corporate coffers through the sale of stock was retained, instead, by those insiders, who then sold the shares at great profit. PA:62. In October 2006, F5 announced that an internal investigation had uncovered irregularities related to option grant practices at the company. PA:3. As F5 told the market:

> Based on its analysis to date, the company anticipates that it may be required to record additional non-cash, stock-based compensation expense of up to $30 million, in the aggregate, for fiscal years 1999 through 2006, to restate its financial statements for fiscal years 1999 through 2005, and to amend its financial statements for the first half of fiscal 2006 . . . .
>
> In light of the expected adjustments described above, the company's financial statements and earnings releases and similar financial communications relating to fiscal periods commencing on or after October 1, 1998, which is the first day of the company's fiscal year 1999, and through the date of this release should no longer be relied upon.

PA:3-4. Stripped of jargon and euphemism, F5 had no choice but to revise its accounting and related financial statements for a seven-year period due to unlawful option backdating. PA:63. Although the parties will formally litigate all fact issues, F5's announcement essentially admitted to the market that backdating was going on at the company. PA:3-4, 63-64.

B. In Federal Court, F5 Treated Delaware Law on Demand Futility as Controlling

F5's statement of the case distills the key events leading to the U.S. District Court's certification order in July 2008. Plaintiffs have one addendum, however, to F5's procedural history.

In its opening brief, F5 argues that RCW 23B.07.400(2) requires "universal demand" and, in any event, this Court should steer clear of Delaware law in construing the statute. In its two motions to dismiss, however, F5 urged the federal court to apply the very precedent it now disparages in this Court. F5 argued plaintiffs had to plead only that demand was futile and that this should be assessed under the "two-pronged test for analyzing a claim of demand futility" announced in *Aronson*. Motion to Dismiss for Failure to Make Demand, p. 10 (Record No. 49). After plaintiffs amended their complaint, F5 moved to dismiss and, once more, cited *Aronson* as controlling the futility inquiry. *See* Motion to Dismiss Amended Complaint for Failure to Make Demand, pp. 23-24 (Record No. 80). As shown below, although F5 has done a turnabout, F5's initial instinct on these legal points was correct.[1]

III. ARGUMENT

A. Shareholder Derivative Actions Play a Critical Role in Holding Corporate Wrongdoers Accountable

1. The Derivative Suit Has Long Been Recognized as a Valuable Tool to Enforce Strict Fiduciary Duties

For nearly as long as the public corporation has existed as a form of business organization, the shareholder derivative action has served an essential companion function. It promotes accountability in corporate governance and ultimately the integrity of capital markets. "Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'" *Kamen v. Kemper Fin. Servs.*, 500 U.S. 90, 95, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991).[2] Among the benefits, "derivative suits have played a rather important role in protecting shareholders of corporations from the designing

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1 At page 27 of its opening brief, F5 drops a footnote making a string of factual assertions without record support. The gist is that F5 purportedly took a number of steps to investigate and remedy the backdating scheme and, as such, a demand on the F5 board would not necessarily have been futile. For the record, plaintiffs dispute the factual assertions but, in any event, they have nothing to do with the issues before this Court.

2 Citations and footnotes are omitted, and emphasis is added, unless otherwise stated.

schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves." *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371, 86 S. Ct. 845, 15 L. Ed. 2d 807 (1966).

Although F5 strains to show otherwise, these very principles animate Washington jurisprudence. This state has no documented hostility to shareholder protections. To the contrary, in circumstances where "the corporation is incapable of enforcing a right of action accruing to it . . . equity will permit a suit to be brought by a stockholder or stockholders to enforce a right of action belonging to the corporation." *Goodwin v. Castleton*, 19 Wn.2d 748, 761, 144 P.2d 725 (1944). The derivative action is necessary where the corporation is controlled by the "guilty parties." *Davis v. Harrison*, 25 Wn.2d 1, 9-10, 167 P.2d 1015 (1946).

Equity's recognition here reflects the stringent nature of defendants' fiduciary obligations. Corporate officers and directors "occupy a fiduciary relation to a private corporation and the shareholders thereof akin to that of a trustee, and owe undivided loyalty, and a standard of behavior above that of the workaday world." *State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wn.2d 375, 381, 391 P.2d 979 (1964). Quoting Cardozo, this Court has emphasized: "'Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.'" *Obert v. Envtl. Research & Dev. Corp.*, 112 Wn.2d 323, 337, 771 P.2d 340 (1989). Although a punctilio of honor may sound old fashioned, courts compel this, as they should, when reviewing claims of options backdating. For example:

> Loyalty. Good faith. Independence. Candor. These are words pregnant with obligation. The Supreme Court did not adorn them with half-hearted adjectives. Directors should not take a seat at the board table prepared to offer only conditional loyalty, tolerable good faith, reasonable disinterest or formalistic candor. It is against these standards, and in this spirit, that the alleged actions of spring-loading or backdating should be judged.

In re Tyson Foods, Inc., No. Civ.A. 1106-CC, 2007 WL 2351071, at *4 (Del. Ch. Aug. 15, 2007).

Ideally, strict fiduciary obligations deter corporate managers from feathering their own nest and infuse them to do what is best for the company and its shareholder owners. "An underlying premise for the imposition of fiduciary duties is a separation of legal control from beneficial ownership." *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998). "The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided." *Id.* at 10. When corporate insiders lose their fiduciary compass, the derivative action "educates corporate directors in the principles of fiduciary responsibility and undivided loyalty." *Brendle v. Smith*, 46 F. Supp. 522, 525 (S.D.N.Y. 1942).

2. Given the Limited Resources Constraining Public Prosecutors, Private Litigation Is Essential to Remedy Corporate Fraud

Indeed, F5's request to gut the shareholder derivative action in this state could not be more untimely. Since the bursting of the high-tech stock market bubble at the beginning of this decade, the United States has been plagued by fraudulent business conduct. Several notorious examples include the financial manipulations by Enron and other companies, the deceitful conduct by market analysts who deliberately distorted their research reports, and the market timing and other abusive practices by mutual fund managers. Such egregious betrayals of the public trust have culminated in perhaps the most dire economic circumstances since the Great Depression.[3]

The practice of granting stock options to corporate officials arose several decades ago as part of a movement to align the pay of executives more directly with the interests of shareholders. Corporate officials would

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[3] *See generally* Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (2003); Kurt Eichenwald, *In a String of Corporate Troubles, Critics Focus on Boards' Failings*, N.Y. Times, Sept. 21, 2003, §1 at 1; Gretchen Morganson, *As Scandals Still Flare, Small Victories for Investors*, N.Y. Times, Mar. 11, 2007, §3 at 1.

thus, according to the theory, have the incentive to increase the price of their companies' shares so they could profit themselves by exercising their options to purchase stock that had risen in value. The stock market, however, is an inherently risky endeavor. When most exchanges plummeted in the early part of this decade, many corporate insiders, as noted, began selecting phony "grant" dates by hindsight to make their options much more profitable. *See* Mark Maremont & Charles Forelle, *Bosses' Pay: How Stock Options Became Part of the Problem*, Wall St. J., Dec. 27, 2006, at A1.

The practice of options backdating first came to light in a study published by University of Iowa Finance Professor Eric Lie. He found that many times there were big jumps in stock prices right after companies represented that their options had been granted, even though no favorable news had been announced that would account for those increases. The obvious explanation for Professor Lie was that corporate executives were consciously changing the grant dates of their options back to low points in their stocks' histories so they could maximize their gain when they exercised them. Professor Lie estimated that this pernicious practice occurred at almost 30 percent of exchange-listed companies. *See* Eric Lie, *On the Timing of CEO Stock Option Awards*, 51 Mgmt. Sci. 802 (2005). Announcing the indictment of former corporate executives for this practice, Deputy U.S. Attorney General Paul McNulty made this candid judgment: "'When options are backdated to a time when the share price was lower, and without honest disclosure, those options are simply theft from shareholders.'" Charles Forelle & James Bandler, *Dating Game – Stock-Options Criminal Charge: Slush Fund and Fake Employees*, Wall St. J., Aug. 10, 2006, at A1. As of March 2007, more than 140 companies were under investigation for options backdating and more than 70 corporate officials had been fired or resigned because of it. *See* Mark Maremont et al., *Companies Say Backdating Used in Days After 9/11*, Wall St. J., Mar. 7, 2007, at A1.

Although there has been some governmental response to this turmoil roiling the capital markets, public prosecutors have limited resources to attack the plague of backdating at so many companies. The Securities and Exchange Commission ("SEC"), the federal agency charged with enforcing the securities laws, to date has brought only approximately 30 civil actions and there has been just one notable criminal conviction. *See* www.sec.gov/spotlight/optionsbackdating.htm (last visited Nov. 12, 2008); *Former CEO to Serve 21 Months for Backdating*, MSNBC, Jan. 16, 2008, www.msnbc.msn.com/id/22685773 (last visited Nov. 12, 2008). Three former chairmen of the SEC stressed recently: "The problem with the S.E.C. today is that it lacks the money, manpower and tools it needs to do its job." William Donaldson, Arthur Levitt, Jr. & David Ruder, *Muzzling the Watchdog*, N.Y. Times, Apr. 29, 2008, at A19.

Appropriately, then, the derivative suit has been called a "needed policeman," Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. Pa. L. Rev. 74, 78 (1967), and "the chief regulator of corporate management." *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548, 69 S. Ct. 1221, 93 L. Ed. 1528 (1949). Empirical evidence demonstrates that "executives tempted to lie about earnings," and who engage in other fiduciary abuses, are more concerned about the "immense deterrent power" of shareholder actions than anything government regulators might do. Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. Pa. L. Rev. 103, 106 (2006). In ensuring clean markets and responsible corporate governance, there has long been a role for stockholder plaintiffs as "private Attorney Generals," a term first coined by the distinguished jurist Jerome Frank. *Associated Indus. of New York State v. Ickes*, 134 F.2d 694, 704 (2d Cir. 1943), *vacated and remanded on other grounds*, *Ickes v. Associated Indus.*, 320 U.S. 707, 64 S. Ct. 74, 88 L. Ed. 414 (1943). Private actions "furnish a benefit to all shareholders by providing an important means of enforcement." *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 396, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970). As another court aptly put the matter, private enforcement in some circumstances "giv[es] point to the only sanctions actual and potential wrongdoers fear." *Pomerantz v. Clark*, 101 F. Supp. 341, 346 (D. Mass. 1951).

B. Washington Is a Demand Futility State

1. Under RCW 23B.07.400 and Its Legislative History, a Presuit Demand Is Excused When It Would Be Futile or Useless

Against this backdrop, F5 invites the Court to whittle away at shareholder protections by flexing its common law muscles. As F5 tells it, "in Washington, the entire concept of derivative litigation is grounded in the common law." Opening Brief of Nominal Defendant F5 Networks, Inc. ("OB") 9. This Court, the reasoning goes, may simply proclaim that Washington follows so-called universal demand. F5's premise is erroneous and, in fact, seeks to divert the Court from the relevant legal sources. As framed by the U.S. District Court's certification order, the issue is actually one of statutory interpretation. RCW 23B.07.400(2) provides for a demand futility standard, and the issue is not close.

In relevant part, Washington's statute instructs that a derivative complaint must "allege with particularity the demand made, ***if any***, to obtain action by the board of directors and either that the demand was refused or ignored or ***why a demand was not made***." RCW 23B.07.400(2). Because the derivative plaintiff may invoke the courts and explain why a demand was not made, the Legislature could not have intended to mandate a presuit demand in virtually all circumstances, as F5 asserts.

A broader view of the Washington Business Corporation Act ("WBCA") confirms this conclusion. The search for plain meaning considers not just the statute directly at issue, but also "related statutes" that shed light on the most reasonable interpretation. *State v. Campbell & Gwinn*, 146 Wn.2d 1, 11, 43 P.3d 4 (2002). As a basic foundational premise, the WBCA "explicitly grants to shareholders the right to bring derivative actions on behalf of corporations." *Lundberg v. Coleman*, 115 Wn. App. 172, 177, 60 P.3d 595 (2002) (citing RCW 23B.07.400), *review denied*, 150 Wn.2d 1010, 79 P.3d 446 (2003). The Legislature could not have meant to empower shareholders to sue derivatively, but then impose a grudging demand rule all but eviscerating this right. When applying statutes, "unlikely, absurd or strained consequences" in this vein "should be avoided." *State v. Fjermestad*, 114 Wn.2d 828, 835, 791 P.2d 897 (1990).

Even assuming for sake of argument that RCW 23B.07.400(2) is susceptible to "more than one reasonable interpretation," the Court would next "employ tools of statutory construction such as legislative history to interpret the statute." *Tesoro Ref. & Mktg. Co. v. Dep't of Revenue*, 164 Wn.2d 310, 317-18, 190 P.3d 28 (2008). Here, the legislative history underscores that the statute provides for demand futility.

Washington is one of many states that patterned its corporate law statutes on national model acts promulgated by the American Bar Association ("ABA"). This lineage has been distilled as follows:

> Common law largely controlled the law of corporations in Washington until statutory enactments changed that law.
>
> In 1965, the Washington State Legislature adopted the Washington Business Corporation Act (WBCA), Laws of 1965, ch. 53, which was based largely on the national Model Business Corporation Act.
>
> In 1984, the national Model Business Corporation Act was revised in response to extensive comment throughout the country. In 1989, the Washington State Legislature substantially revised the WBCA, Laws of 1989, ch. 165, to incorporate many provisions of the national 1984 Revised Model Business Corporation Act (Model Act).

Ballard Square Condo. Owners Ass'n v. Dynasty Constr. Co., 158 Wn.2d 603, 620-21, 146 P.3d 914 (2006) (J.M. Johnson, J., concurring). The particular section at issue here, RCW 23B.07.400(2), was enacted in 1989 as part of the last major WBCA revision.

A rich legislative history on the 1989 statutory revamp is found in the Senate Journal. As this Court has explained, the official comments "included in the Senate Journal, 51st Legis. 2977-3112 (1989)" are "indicative of legislative intent." *Equipto Div. Aurora Equip. Co. v. Yarmouth*, 134 Wn.2d 356, 366, 950 P.2d 451 (1998); *see also Ballard Square*, 158 Wn.2d at 623

(J.M. Johnson, J., concurring). Courts thus rely on the Senate Journal comments when resolving statutory interpretation issues under the WBCA.[4]

The Senate Journal explains that under RCW 23B.07.400(2), the derivative plaintiff should make a presuit demand "in most circumstances." PA:120 (quoting Senate Journal, 51st Legis. 3031 (1989)). Nonetheless, "there may be circumstances showing that a demand on the board of directors would be useless, and in those circumstances it should be sufficient to allege the reasons why the plaintiff did not make the demand." PA:120. Hence, if "[t]he goal of statutory interpretation is to carry out the legislature's intent," as this Court has often instructed, then the proper gloss here is no mystery. *Tesoro*, 164 Wn.2d at 317. Although not restricting the circumstances under which demand will be excused, RCW 23B.07.400(2) is fundamentally a demand futility statute.

Unable to ignore the legislative guidance, F5 tries to bury the Senate Journal passage in a footnote. F5 professes uncertainty over "what 'useless' means in this context." OB18 n.11. "Importantly," F5 asserts, "the term '***futility***' does not appear anywhere in the MBCA or WBCA commentary on derivative procedures. " *Id.* (emphasis in original). With all respect, this is

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4 *See, e.g.*, *Ballard Square*, 158 Wn.2d at 614 n.7; *Equipto*, 134 Wn.2d at 366-67, 369, 371; *Sound Infiniti, Inc., ex rel. Pisheyar v. Snyder*, 145 Wn. App. 333, 345-46, 186 P.3d 1107 (2008).

quibbling. Courts treat "futile" and "useless" in this context as interchangeable. "Equity will not require a useless act . . . . Where demand upon the board would be 'futile,' the demand requirement will be excused." *Heineman v. Datapoint Corp.*, 611 A.2d 950, 952 (Del. 1992), *overruled in part on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).[5]

Indeed, the doctrine of futility is deeply embedded in this Court's jurisprudence. "We think it is the general rule that a demand is never necessary where it would be unavailing if made." *Burrows v. McCalley*, 17 Wash. 269, 276, 49 P. 508 (1897). This reflects that "equity does not require the doing of a useless thing." *State v. Fulwiler*, 76 Wn.2d 313, 324, 456 P.2d 322 (1969). "It is Hornbook law that the law does not require a useless act." *Franklin County Sheriff's Office v. Sellers*, 97 Wn.2d 317, 334, 646 P.2d 113 (1982). Given these settled propositions, it is unremarkable the Legislature adopted a demand futility standard in RCW 23B.07.400(2). F5 has certainly cited no relevant authority for reading the statute any other way.

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5 *See also Kaster v. Modification Sys., Inc.*, 731 F.2d 1014, 1017 (2d Cir. 1984) ("demand is excused if the demand would be 'futile,' 'useless' or 'unavailing'"); *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1141 (Kan. 1978) ("futile or useless"); *Tasner v. Billera*, 379 F. Supp. 815, 825 (N.D. Ill. 1974) ("a useless act or an idle ceremony or completely futile").

2. Before RCW 23B.07.400, Washington Courts Recognized Demand Futility

As noted, Washington corporations were governed by common law until the WBCA was enacted in 1965 and then revised substantially in 1989. This evolution from common to statutory law has spawned lively debates on whether the WBCA abrogated common law, or coexists with it. *Compare Ballard Square*, 158 Wn.2d at 610 (majority opinion) *with id.* at 621 (J.M. Johnson, J., concurring). Simplifying the resolution of this case, no such issue is presented here. Before the Legislature enacted RCW 23B.07.400, Washington courts applied, in today's parlance, a demand futility standard.

In *Williams v. Erie Mountain Consol. Mining Co.*, 47 Wash. 360, 91 P. 1091 (1907), the trial court overruled a demurrer contending that shareholders suing derivatively had "no legal capacity to sue." *Id.* at 361. On appeal, the judgment was challenged on the theory that "there was no demand upon the corporation or its officers to bring suit." *Id.* Rejecting the argument, this Court affirmed and explained:

> "In the state courts it is generally held that a stockholder may excuse a failure to demand corporate action by showing that the persons charged with the wrongdoing, and who would be parties defendant to the action, are still in control of the corporation as directors, or that the wrongdoers control a majority of the board of directors, or by proof of any other facts which clearly show that a demand for corporate action would have been useless."

Id. at 363. *Williams* illustrates, moreover, that managerial self-dealing (such as options backdating) is the type of harm that may be remedied in a derivative suit. The derivative "'right of action arises . . . where the directors and officers are acting, not in faithful discharge of their trust, but are perverting their official powers to their own personal gain and benefit, and in fraud of the rights of the shareholders.'" *Id.*

Seeking to explain away a century of case law, F5 denigrates this Court's precedent as "confusing and inconclusive." OB15. There is nothing inartful or ambiguous about it. In other early decisions, this Court recognized there must be judicial recourse for stockholders to attack breaches of fiduciary duty harming the corporation, without requiring useless presuit demands on the wrongdoers. *See Elliott v. Puget Sound Wood Prods. Co.*, 52 Wash. 637, 641, 101 P. 228 (1909); *Kneeland Inv. Co. v. Berendes*, 81 Wash. 372, 376, 142 P. 869 (1914).

More recent Washington decisions reinforce this point. "Under exceptional circumstances, one or more of its corporate stockholders may sue to enforce the corporate right by way of a derivative suit. Such a suit is one in equity to enforce a corporate right which the corporation fails, is ***unable***, or refuses to assert by court action." *La Hue v. Keystone Inv. Co.*, 6 Wn. App. 765, 777, 496 P.2d 343 (1972), *review denied*, 81 Wn.2d (1972). Although derivative actions have been described as "disfavored" – a word F5 seeks to overplay – this simply means such cases are brought in "exceptional circumstances." *Haberman v. Washington Pub. Power Supply Sys.*, 109 Wn.2d 107, 147, 744 P.2d 1032 (1987) (citing *La Hue*). These do not include, as in *Haberman* itself, where bondholders are constrained by their own contractual commitments from suing derivatively. By contrast, futility of demand is one exceptional circumstance allowing a derivative action. "The doctrine of futility excuses demand on directors when the majority of the directors are the alleged wrongdoers." *Id.* at 154.

3. A Shift to "Universal Demand" Is for the Legislature

In short, both RCW 23B.07.400(2) and preexisting case law confirm that Washington is a demand futility state. F5's request for universal demand disregards a cardinal admonition. "'Courts do not amend statutes by judicial construction . . . .' We show greater respect for the legislature by preserving the legislature's fundamental role to rewrite the statute rather than undertaking that legislative task ourselves." *In re Parentage of C.A.M.A.*, 154 Wn.2d 52, 69, 109 P.3d 405 (2005). A few additional considerations highlight that a seismic shift to universal demand is for the Legislature.

Significantly, the arrival of universal demand as a legal doctrine postdates RCW 23B.07.400(2). As even F5 acknowledges, the 1989 WBCA was patterned on the ABA's 1984 model act. *See Equipto*, 134 Wn.2d at

361. The ABA, however, did not modify its model act to propose universal demand until after the WBCA revision. *See* Committee on Corporate Laws, *Changes in the Model Business Corporation Act – Amendments Pertaining to Derivative Proceedings*, 45 Bus. Law. 1241 (1990).

F5 cites no authority for its assumption that subsequent model acts, restatements of law and the like may be used to put a new and fundamentally different gloss on RCW 23B.07.400(2). OB21-22, 25-28. Courts, in fact, reject this unorthodox method of statutory interpretation. The "approach expressly adopted by the MBCA drafters" in the ABA's 1984 model act, and then adopted by the Legislature for Washington in 1989, must control. *Sound Infiniti*, 145 Wn. App. at 346 n.3. Although the ABA's model act has evolved, this factor supports plaintiffs' reading of RCW 23B.07.400(2), not F5's interpretation. In ascertaining legislative intent, key is that the Legislature has not enacted the recent model act changes. "[W]hen the model act in an area of law contains a certain provision, but the legislature fails to adopt such a provision, our courts conclude that the legislature intended to reject the provision." *Lundberg*, 115 Wn. App. at 177-78.

Apart from timing issues, universal demand breaks from the traditional common law rule excusing demand when it would be "useless" or an exercise in "futility." *Williams*, 47 Wash. at 363; *Haberman*, 109 Wn.2d at 154. In light of this departure, the legislative route is how states have overwhelmingly approached the subject. With just one exception, every jurisdiction to adopt universal demand has made this change by statute. F5 so demonstrates by collecting the state statutes in a footnote. OB22 n.14. Unsurprisingly, a true universal demand statute reads very differently. *See, e.g.*, Miss. Code Ann. §79-4-7.42. No state following universal demand has a statute written like RCW 23B.07.400(2). And, no state following universal demand provides, as the Washington Legislature did, that demand is excused when it would be "useless." PA:120.

The only exception to the legislative approach proves the rule. In *Cuker v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042 (1997), the court adopted wholesale a set of American Law Institute principles governing derivative litigation. *Id.* at 611-14. In contrast to Washington and many other states, the Pennsylvania Legislature had not promulgated a demand statute. Pennsylvania's common law exception for demand futility was already "extremely limited," so judicial adoption of universal demand there made little practical difference. Luke J. Bergstrom, *Supreme Court's Cuker Decision Clarifies Shareholder Derivative Litigation in Pennsylvania*, 69 Pa. Bar Ass'n Quarterly 25, 26 (1998).

More analogous is the experience of several other states. Tennessee's demand statute, also based on the 1984 model act, is identical to Washington's. Tenn. Code Ann. §48-17-401(b). Tennessee common law has long provided that demand is excused when it is an "'idle ceremony.'" *Lewis on behalf of Citizens Sav. Bank & Trust Co. v. Boyd*, 838 S.W.2d 215, 221 (Tenn. Ct. App. 1992). Rejecting a universal demand interpretation, the Tennessee Court of Appeals held that "[t]he demand requirement fashioned in [the] early cases is now embodied" in the Tennessee statute. *Id.* The court emphasized that Tennessee's law "does not contain the universal demand requirement" the ABA added to its model act only later. *Id.* at 222 n.3.

New York's demand statute resembles Washington's as well. N.Y. Bus. Corp. Law §626(c). When presented with the issue, the New York Court of Appeals declined to scrap demand futility in favor of universal demand. "Since New York's demand requirement is codified," the court explained, "universal demand may only be adopted by the Legislature." *Marx v. Akers*, 88 N.Y.2d 189, 198, 666 N.E.2d 1034 (1996). The court found significant that "New York State has also considered and continues to consider implementing a universal demand requirement," but "the Legislature has yet to enact a universal demand requirement." *Id.* at 197. The same is true as to the Washington Legislature.

The Indiana Supreme Court too has declined an invitation to declare universal demand by judicial fiat. According to F5, the Indiana decision "guts the futility exception and effectively results in a 'universal' demand standard," thereby "preserv[ing] the demand futility exception in name only."

OB42-43. This description is, to put it kindly, far fetched. Interpreting a similarly worded demand statute, the Indiana Supreme Court actually held that Indiana "retains the futility standard" and, moreover, "the Indiana BCL does not impose universal demand." *In re Guidant S'holders Derivative Litig.*, 841 N.E.2d 571, 572 (Ind. 2006) (original caps and bold omitted). Although F5 seeks to paper over the point, Indiana's futility exception was narrowed based on an unusual statute giving great deference to special litigation committees. *Id.* at 574-75. As Indiana's high court emphasized, "[t]his section of our law has no . . . counterpart" in the ABA's 1984 model act. *Id.* at 575. Notably, it also has no counterpart in the WBCA at issue here. Thus, to the extent analogous, *Guidant* supports plaintiffs, not F5.

Like the courts in Tennessee, New York and Indiana, the Maryland Court of Appeals adds to this chorus by refusing to legislate a new universal demand rule for that state. The Maryland court explained that universal demand was "a radical departure from our current common law." *Werbowsky v. Collomb*, 362 Md. 581, 618, 766 A.2d 123 (2001). The court stressed that "this is a matter that should be subjected to legislative hearings, at which all interested groups, and not just the litigants in one case, can present their views." *Id.* Similarly, North Carolina appellate jurisprudence shifted from demand futility to universal demand only after state lawmakers amended the corporate code to provide for universal demand. This was simply a matter of applying the new statute "'as written.'" *Norman v. Nash Johnson & Sons' Farms, Inc.*, 140 N.C. App. 390, 410, 537 S.E.2d 248 (2000), *review denied*, 353 N.C. 378, 547 S.E.2d 13, 547 S.E.2d 14 (2001). Other decisions emphasize fidelity to legislative intent. *See also Gottesfeld v. Richmaid Ice Cream Co.*, 115 Cal. App. 2d 854, 860, 252 P.2d 973 (1953) (presuit demand excused as "useless" where statute allowed plaintiff to explain "'reasons for not making such effort'"). What F5 proposes – going to universal demand but skipping the statutory amendment – is unfaithful to judicial restraint.

Nor is universal demand a compelling approach. Although F5 sings its praises, this doctrine has not been universally embraced, and with good reason. Under universal demand, the board of directors wields nearly absolute power over the choice to sue, even where the case would be brought against the board for its own misconduct. As the U.S. Supreme Court observed, this tilts the playing field too heavily in the board's favor. "Superimposing a rule of universal-demand," in place of the traditional demand futility standard, "would clearly upset the balance [states] have struck between the power of the individual shareholder and the power of the directors to control corporate litigation." *Kamen*, 500 U.S. at 103.

Indeed, the notion of universal demand needs to be considered in the larger context of how derivative litigation is regulated. Contrary to F5's suggestion, it is not easy to prosecute such actions successfully after passing arguments over presuit demand. A shareholder bold enough to take on the board, with even highly meritorious claims, must navigate multiple statutory requirements. In Washington, these include shareholder standing limitations, verified complaints, judicial power to stay the case while the corporation investigates the derivative claim, court approval of settlements or dismissals, notice to shareholders if the resolution will substantially affect their rights, and even payment of defense expenses within the court's discretion for abusive derivative litigation (thereby deterring "strike suits"). *See* RCW 23B.07.400. If added to these strictures, universal demand would, practically speaking, gut the derivative action as a tool for holding corporate wrongdoers accountable.

The purportedly superior efficiency of universal demand, moreover, is illusory. The high court correctly predicted that universal demand, where it is embraced, will "merely shift the focus of threshold litigation from the question whether demand is excused to the question whether the directors' decision to terminate the suit is entitled to deference." *Kamen*, 500 U.S. at 106. Also, universal demand statutes typically recognize an exception, allowing the plaintiff to sue immediately, if "irreparable injury to the corporation would result by waiting for the expiration of the ninety-day period." Miss. Code Ann. §79-4-7.42(2). Irreparable injury is another issue that must be litigated where, as often occurs, a shareholder acts to protect the corporation before the waiting period expires. Hence, rather than reducing collateral litigation, universal demand trades a court fight over demand futility for litigation over other issues. *See Kamen*, 500 U.S. at 106-07.

At any rate, the asserted benefits of a new demand statute for Washington should be debated in a different branch of government. Because RCW 23B.07.400(2) currently provides for demand futility, F5's preoccupation with "policy considerations" is actually "not material for the purposes of this discussion." *Lyzanchuk v. Yakima Ranches Owners Ass'n, Phase II*, 73 Wn. App. 1, 6, 866 P.2d 695 (1994) (interpreting Washington Nonprofit Corporation Act). F5 "must take [its] case" for amending the statute "to the legislature." *Lundberg*, 115 Wn. App. at 178.

C. This Court Should Endorse *Aronson v. Lewis* as Providing Persuasive Guidance on When Demand Will Be Excused as Futile

1. Delaware Has Preeminence on Matters of Corporate Law

The second part of the U.S. District Court's certified question asks whether "Washington follows Delaware's demand futility standard." Certification Order, p. 2 (Record No. 98). Besides Judge Lasnik, federal courts applying Washington law have understood as much. As stated in one recent decision, "the Court concludes that the Washington State Supreme Court would likely adopt the substantive demand requirement and apply a similar, if not the same, exception for futility as that employed in Delaware." *In re Cray Inc. Derivative Litig.*, 431 F. Supp. 2d 1114, 1120 (W.D. Wash. 2006) (Zilly, J.). Another local federal judge did the same, explaining that "[t]he parties agree with Judge Zilly's analysis of this point." *Schwartzman v. McGavick*, No. C06-1080P, 2007 WL 1174697, at *4 (W.D. Wash. Apr. 19, 2007) (Pechman, J.) (same counsel representing F5 here). Moreover, as noted above, F5 urged Judge Lasnik to apply *Aronson*, at least before F5 sensed an opportunity to revisit its position. *See Save Columbia v. Columbia*, 134 Wn. App. 175, 186, 139 P.3d 386 (2006) (discussing judicial estoppel). Plaintiffs submit that all these courts and litigants were on the right track.

As Professor Folk so aptly put it, "viewed realistically, Delaware corporation law is national corporation law." Ernest L. Folk, III, *The Delaware General Corporation Law* xiii (1972). His comments are as true today as when they were first made. For example, the New Mexico Supreme Court followed Delaware law last year because it is the "'fountainhead of American corporations' whose courts 'are known for their expert exposition of corporate law.'" *McMinn v. MBF Operating Acquisition Corp.*, 142 N.M. 160, 172, 164 P.3d 41 (2007) (collecting cases). "'Delaware is recognized as a pacesetter in the area of corporate law.'" *IBS Fin. Corp. v. Seidman & Assocs., L.L.C.*, 136 F.3d 940, 950 (3d Cir. 1998).

At first blush, Delaware's preeminence in American corporate jurisprudence may seem perplexing. Under a cornerstone principal of conflicts of law, however, the rules of the state where a business is incorporated govern how it is to be run. *See CTS Corp v. Dynamics Corp. of Am.*, 481 U.S. 69, 89-91, 107 S. Ct. 1637, 95 L. Ed. 2d 67 (1987). Because of that "internal affairs doctrine," Delaware has been successful in attracting incorporations by historically presenting itself as a friendly home for corporate management. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974). It is debatable whether Delaware is as pro-management as in former years. Nonetheless, as noted by a former professor and associate dean at Seattle University Law School, Delaware remains the most popular state of incorporation for large, publicly-held companies as well as for smaller firms not incorporated in their home states. *See* Eric Chiappinelli, *Cases and Materials on Business Entities* 123 (2006).

Bayless Manning, the former Dean of Stanford Law School, put it well in explaining his preference for Delaware in matters of corporate law:

> I happen to be particularly fond of the state of Idaho. I have a home and spend a good bit of time there . . . but even I would not argue that one should choose that jurisdiction for litigation of a complex question of corporate law . . . . In Delaware I will be dealing with pros . . . my Delaware Counsel and I will have a wise range and sophisticated body of corporation law – a jurisprudence if you will – to bring to

> bear on almost any problem that will arise. No other jurisdiction can provide so much. That is why Delaware is in fact national, and why its own gravitational pull tends to attract more companies each year and thereby further reinforce its preeminence.

Bayless Manning, *State Competition: Panel Response*, 8 Cardozo L. Rev. 779, 785-86 (1987). A prominent casebook underscores these observations: "Corporations prefer to litigate issues in Delaware rather than elsewhere because of the knowledge, expertise, sophistication, and experience of the Chancellor and four Vice Chancellors on corporate matters." Robert W. Hamilton & Jonathan R. Macey, *Corporations Including Partnerships and Limited Liability Companies* 203 (2007).

In addition, two published experts on Washington corporate law echo this view, citing Delaware's "well-developed corporate case law" as a leading consideration for Washington companies to incorporate there. Stewart M. Landefeld & Eric A. Dejong, *Washington Business Entities, Law & Forms* §1.13, at 1-24 (2d ed. 2007). Other commentators have cited the special expertise of the Delaware judiciary in corporate matters as a reason why it attracts the lion's share of incorporations. *See, e.g.*, Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation*?, 20 Del. J. Corp. L. 965, 975-76 (1995).

2. *Aronson* Is Sound and Widely Followed

The Delaware inquiry for excusing demand is found in *Aronson* and a case elaborating it, *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). Delaware's approach provides the appropriate assessment for when directors are too conflicted to take action against the alleged wrongdoers, either because they were complicit in the illegality or under the control of the culpable parties. The Delaware test requires more than just blanket charges of such a situation. In line with CR 23.1, *Aronson* details how a plaintiff has to allege "with particularly" sufficient reasons for not making demand. To do so, the plaintiff must state facts in the complaint to create "a reasonable doubt . . . that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson*, 473 A.2d at 814.

In subsequent cases, the Delaware Supreme Court has elaborated on that standard. It has described the two prongs as alternatives, so satisfying either one will excuse demand. *See Levine v. Smith*, 591 A.2d 194 (Del. 1991). In addition, it has further explained the test's standard of proof as requiring that the plaintiff show a "reasonable belief" (something more than "mere suspicions") that the board either lacked independence or that the transaction was not protected by the business judgment rule. *Grimes v. Donald*, 673 A.2d 1207, 1217 (Del. 1996).

As to the first prong, the plaintiff must allege in more than just conclusory terms that a majority of the directors were interested in the questioned transactions or otherwise conflicted. Another Delaware case provides additional guidance on that point, noting "[d]irectorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders." *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). If that is the case, then the directors should not be able to decide whether the corporation pursues litigation to redress injury to it from the suspect transaction.

As to the second prong, the plaintiff must be able to plead facts showing that the transaction was so egregious on its face that the board could be said to have acted either in bad faith or in a grossly negligent fashion. *See* Del. Code Ann. tit. 8, §102(b)(7); *Smith v. Van Gorkom*, 488 A.2d 858, 864 (Del. 1985). Delaware's Court of Chancery has further refined this inquiry, ruling that for demand to be excused "plaintiffs must plead particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision." *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003).

The *Aronson* test is sufficiently rigorous and evinces an evenhanded approach to the question of when demand should be excused. It constitutes an appropriate barrier against so-called "strike suits," meaning claims that might be brought with little basis solely to extract quick settlements. *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*?, 7 J.L. Econ. & Org. 55, 55-56 (1991). *Aronson* therefore serves as a good mechanism for separating ex ante the wheat (meritorious claims) from the chaff (frivolous actions). The test eliminates baseless suits where there is only an unsubstantiated sense that the directors are culpable of wrongdoing. Yet it permits shareholders to prosecute much needed actions against true corrupt corporate conduct. Legitimate derivative suits can go forward, as they should, when shareholders are able to articulate specific facts that show a board is fatally compromised and unable to independently judge a matter either because of its own interest or its failure to exercise proper business judgment.

As with Delaware corporate law generally, its test for determining demand futility has been widely embraced – notwithstanding F5's attempt to argue otherwise. Two years ago, for example, the Nevada Supreme Court adopted *Aronson* as its state's benchmark for when demand would be excused because it provides a more balanced assessment to demand futility than an earlier approach Nevada had taken. *See Shoen v. Sac Holding Corp.*, 137 P.3d 1171, 1180 (Nev. 2006). The Nevada high court called Delaware's approach "a well-reasoned method for analyzing demand futility." *Id.* at 1184. On a similar rationale, Oregon recently followed *Aronson*. *See Crandon Capital Partners v. Shelk*, 219 Or. App. 16, 29-30, 181 P.3d 773 (2008), *review denied*, 345 Or. 158, 190 P.3d 379 (2008). Many other states have done the same.[6] In addition, because of the internal affairs doctrine, the *Aronson* test has been followed by federal and state courts when adjudicating derivative actions dealing with companies incorporated in Delaware.[7] Such widespread adoption has made the Delaware test for demand futility pervasively influential in the American legal system.

3. F5's Objections to *Aronson* Lack Merit

F5's principal objection to the *Aronson* test seems to be that it is too lenient, thereby unduly divesting the board of its prerogative to manage a company's litigation. F5 asserts that it will be easy for plaintiffs "to imagine (or concoct) reasons that a corporate director theoretically might not be

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6 By way of illustration, *Aronson* has also been followed in Arizona (*Blumenthal v. Teets*, 155 Ariz. 123, 745 P.2d 181 (1987)); California (*Oakland Raiders v. Nat'l Football League*, 93 Cal. App. 4th 572, 113 Cal. Rptr. 2d 255 (2001)); New Jersey (*In re PSE&G S'holder Litig.*, 173 N.J. 258, 801 A.2d 295 (2002)); and Illinois (*In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 806-07 (7th Cir. 2003)).

7 *See, e.g.*, *RCM Sec. Fund, Inc. v. Stanton*, 928 F.2d 1318, 1330-34 (2d Cir. 1991); *Blasband v. Rales*, 971 F.2d 1034, 1047-54 (3d Cir. 1992); *McCall v. Scott*, 239 F.3d 808, 816-17 (6th Cir. 2001); *Prof'l Mgmt. Assocs. v. Coss*, 574 N.W.2d 107, 110-11 (Minn. Ct. App. 1998), *review denied*, 1998 Minn. LEXIS 196 (Minn. Apr. 14, 1998).

'disinterested' in alleged wrongdoing that occurred on that director's watch." OB35-36. In an article cited by F5, a distinguished corporate law scholar states that just the opposite is true. Professor Coffee concludes that *Aronson* "rarely can be satisfied in the case of a publicly held corporation having a board with a majority of outside directors." John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 Bus. Law. 1407, 1412 (1993).

F5 also relies on a federal judge's separate opinion – writing only for himself nearly two decades ago – that *Aronson*'s "reasonable doubt" language requires too little a showing to disqualify directors from managing the firm's litigation. *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1175 (7th Cir. 1989) (Easterbrook, J., concurring). Since then, however, the Delaware Supreme Court has made clear that particularized facts showing something more than just suspicion or conclusory beliefs must be pled to establish that directors were either interested in the questioned transaction or failed to exercise their proper business judgment. *See Grimes*, 673 A.2d at 1217. Further, merely naming a majority of the directors as defendants or suing a party who can control them is not enough to show that the directors lack independence. *See Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983). Nor will merely demonstrating that a majority of them are connected with the culpable party through business or social ties suffice either for that purpose. *See Beam v. Stewart*, 845 A.2d 1040, 1044 (Del. 2004).

F5 posits that *Aronson*'s "reasonable doubt" standard is too elusive and spawns excessive litigation. To be sure, "reasonable doubt" is fact-specific, but this should not disqualify such a familiar standard. Again, at issue here is striking the right balance. The Delaware Supreme Court has noted that "'[t]he "reasonable doubt" standard "is sufficiently flexible and workable to provide the stockholder with 'the keys to the courthouse' in an appropriate case where the claim is not based on mere suspicions or stated solely in conclusory terms."'" *Id.* at 1050.

Also baffling is F5's reliance on a law review article claiming the demand futility doctrine is "irrational because it makes the demand requirement turn on the court's uninformed prediction of how the case will turn out on the merits." Jeffrey S. Facter, *Fashioning a Coherent Demand Rule for Derivative Litigation in California*, 40 Santa Clara L. Rev. 379, 393 (2000). On the contrary, the Delaware test uses particularized pleading requirements to weed out baseless actions from those legitimately prosecuting corporate corruption and malfeasance. The article by Justice Jacobs of the Delaware Supreme Court, also cited by F5, corroborates this point. "Indeed, an important purpose of the *Aronson* approach to the demand requirement is to screen out, at the earliest stage, derivative litigation that will likely prove to be groundless." Jack B. Jacobs, *The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay*, 41 Suffolk U. L. Rev. 1, 7 (2007). Time and experience have shown that *Aronson* checks misuse of the derivative action while keeping the courthouse doors open to check abuses and legal violations by corporate fiduciaries.

D. *Ryan v. Gifford*, Specifically Involving Demand Futility in the Options Backdating Context, Is Also Sound and Widely Followed

1. *Ryan* Strikes the Appropriate Balance

Finally, the U.S. District Court has asked, does Washington "follow the reasoning of *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) in cases where the improper backdating of stock options has been alleged?" Certification Order, p. 2 (Record No. 98). The answer should be yes.

The Court of Chancery's decision in *Ryan* was the first in Delaware to apply *Aronson*'s demand futility test in the context of stock option backdating. Chancellor Chandler's carefully reasoned opinion set forth a detailed analysis of what derivative plaintiffs alleging options backdating must plead in order to show demand futility. Despite F5's assertions to the contrary, *Ryan* is widely followed and regarded as the leading authority on demand futility in the options backdating context. *Ryan*'s reasoning is persuasive and should therefore be adopted by this Court.

Shareholders in *Ryan* brought a derivative suit highly analogous to this case, as discussed further below. According to the complaint, the board members of Maxim Integrated Products, Inc. breached their fiduciary duties by approving or receiving backdated stock options in violation of a shareholder-approved stock incentive plan. Because the compensation committee members who approved the backdated options in *Ryan* also comprised half of the board at the time the complaint was filed, the court concluded the committee's approval "may be imputed to the entire board for purposes of proving demand futility" and "the *Aronson* test applies." *Ryan*, 918 A.2d at 353.

In considering the second prong of *Aronson*, regarding whether there is "reason to doubt that . . . the challenged acts were the product of the board's valid exercise of business judgment," the Chancery Court concluded plaintiffs had easily provided sufficient particularity to survive a motion to dismiss for failure to make a presuit demand. *Id.* at 352. The plaintiffs pointed to nine specific grants between 1998 and 2002 that occurred during the lowest market price of the month or year, and provided the results of a statistical analysis showing the average annualized return on "sporadic" grants to management was almost ten times higher than the annualized market returns generally in the same period. *Id.* at 354-55. Accordingly, the court determined the timing of the option grants "seems too fortuitous to be mere coincidence." *Id.* at 355.

In addition, the Chancery Court held it "cannot be . . . a valid exercise of business judgment" for a board to backdate stock options when the terms of shareholder-approved stock option plans ***require*** that options be granted at the stock's fair market value on the grant date and provide no discretion for the board to alter the exercise date. *Id.* at 354. The court reasoned that "[a]ltering the actual date of the grant so as to affect the exercise price contravenes the plan," and "[a] board's knowing and intentional decision to exceed the shareholder's grant of express (but limited) authority raises doubt regarding whether such decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand." *Id.*

The *Ryan* complaint also alleged that Maxim's board made false public disclosures to shareholders and the SEC and that the active violations of the option plans resulted in overstated profits and reduced earnings to the company. As a result, the company would be adversely affected by tax and accounting rules and Maxim's financial statements and tax reports would likely need to be restated. *Id.* at 348. In light of these allegations, there was "reason to doubt that the challenged transactions resulted from a valid exercise of business judgment." *Id.* at 354. The court further stressed the gravity of the misconduct in a backdating case:

> A director who approves the backdating of options faces at the very ***least*** a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty. Backdating options qualifies as one of those "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."

Id. at 355-56 (emphasis in original) (quoting *Aronson*, 473 A.2d at 815).

F5's attack on *Ryan* is unconvincing. F5 argues that *Ryan* "sets the bar ***much*** too low for a would-be derivative plaintiff," because the court "did not require the plaintiffs to adduce ***any*** evidence that fraudulent 'backdating' actually occurred." OB46 (emphasis in original). F5's argument, however, ignores the principle that "the pleader is not required to plead evidence." *Brehm*, 746 A.2d at 254. As Judge Robart explained in following *Ryan*, "the question is whether the plaintiff has alleged circumstances from which it may be reasonably inferred that backdating as opposed to an innocent bookkeeping error occurred." *Edmonds v. Getty*, 524 F. Supp. 2d 1267, 1272 (W.D. Wash. 2007). This touchstone recognizes that before discovery, few if any shareholders can plead with assurance "'precisely what defendants knew about backdating . . . and exactly when they knew it.'" *Id.* at 1277.

Ryan rejected a similar objection. There, it was argued that the backdating allegations were not particularized because they failed to allege the board's actual knowledge. Disagreeing, the court reasoned:

> [I]t is difficult to understand how a plaintiff can allege that directors backdated options ***without*** simultaneously alleging that such directors ***knew*** that the options were being backdated. After all, any grant of options had to have been approved by the committee, and that committee can be reasonably expected to know the date of the options as well as the date on which they actually approve a grant.

Ryan, 918 A.2d at 355 n.35 (emphasis in original). This inference at the pleading stage of board knowledge is logically sound. F5 overlooks that proving the case is "for another day." *Conrad v. Blank*, 940 A.2d 28, 40 n.22 (Del. Ch. 2007).

2. Statistical Analysis Is Commonly Used to Support a Reasonable Inference of Backdating

F5 challenges the use of statistical analysis that evaluates option grants to show patterns of backdating. The Merrill Lynch analysis is one such methodology. PA:93. It "measure[s] the extent to which stock price performance subsequent to options pricing events diverged from stock price performance over a longer period of time to measure the aggressiveness of the timing of option grants." *Ryan*, 918 A.2d at 354. Specifically, the analysis looks at "annualized stock price returns for the twenty day period subsequent to options pricing in comparison to stock price returns for the calendar year in which the options were granted." *Id.* at 346. F5 argues the use of such a statistical analysis is "flawed" and "effectively meaningless" because "it is a virtual ***certainty*** that at least some of the many thousands of U.S. companies granting options would, purely by chance, have grant patterns that coincide with stock low-points and appear unreasonably 'lucky.'" OB47-48 (emphasis in original).

F5's contention, however, misses the point of drawing on this methodology to plead a claim for relief. The Merrill Lynch analysis shows the annualized percentage return on grants to management compared to the annual return to the average shareholder during applicable time periods. The Merrill Lynch analysis thus supports the theory that if option grant dates are truly selected at random, there should not be unusually high annualized returns on options granted to officers and directors compared to public investors. PA:22-24. Under these circumstances, as the Chancery Court held, it is reasonable to infer backdating. *See Ryan*, 918 A.2d at 354-55.

Moreover, contrary to F5's assertions, *Ryan* did not look at the Merrill Lynch analysis in a vacuum. Rather, the Chancery Court looked to "specific grants, specific language in option plans, specific public disclosures, and supporting empirical analysis to allege knowing and purposeful violations of shareholder plans and intentionally fraudulent public disclosures." *Id.* at 355. The Merrill Lynch methodology on option grants is simply one of several ways a court may "reasonably infer" that backdating occurred. "[The Merrill-Lynch analysis] emphatically suggests that either defendant directors knowingly manipulated the dates on which options were granted, or their timing was extraordinarily lucky. Given the choice between improbable good fortune and knowing manipulation of option grants, the Court may reasonably infer the latter, even when applying the heightened pleading standards of Rule 23.1." *Id.* at 355 n.34. Other courts have widely accepted the Merrill Lynch methodology for this purpose.[8]

F5's nit-picking of the Merrill Lynch analysis also disregards the settled procedural rules cabining the motion to dismiss that F5 chose to bring. To counter the Merrill Lynch analysis, F5 relies heavily on the pro-industry report issued by the NERA Economic Consulting firm. Based on this report, F5 urges that various inferences and conclusions be drawn in defendants' favor. OB47-48. Under basic rules of procedure, however, "[r]esolution of a battle of expert sources – as defendants expect to occur here – is inappropriate on a motion to dismiss." *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 709 n.9 (3d Cir. 1996). Even with the requirement to plead demand futility "with particularity," a court "draws all reasonable inferences

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[8] *See also Edmonds*, 524 F. Supp. 2d at 1274; *Conrad*, 940 A.2d at 40 n.30; *In re Computer Scis. Corp. Derivative Litig.*, No. CV 06-05288 MRP (Ex), 2007 WL 1321715, at *14 (C.D. Cal. Mar. 26, 2007); *In re Affymetrix Derivative Litig.*, No. C 06-05353 JW, 2008 U.S. Dist. LEXIS 86187, at *11 (N.D. Cal. Mar. 31, 2008).

from the complaint's allegations in the plaintiff's favor," not defendants' favor. *Weiss v. Swanson*, 948 A.2d 433, 441 (Del. Ch. 2008). F5 overlooks that on a motion to dismiss, courts are "bound to give plaintiffs the benefit of every reasonable inference, not to give defendants the benefit of every doubt." *Tyson*, 2007 WL 2351071, at *4.

Consequently, as in *Ryan*, plaintiffs may rely on the Merrill Lynch study to state a claim for relief. The Chancery Court has reaffirmed it is "not persuaded that it should ignore" the Merrill Lynch analysis in options backdating cases. *Conrad*, 940 A.2d at 39 n.30. However, contrary inferences potentially favorable to the defense, and supporting evidence to the same end (such as the NERA report), simply do not come into play.[9]

3. *Ryan* Is the Leading Authority and Is on Point

Seeking to make a parody of *Ryan*, F5 calls the decision a "dangerous anomaly." OB45 (capitalization and bold omitted). Courts, however, overwhelmingly disagree. F5 is the one marching out of step here.

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[9] There was some uncertainty in the U.S. District Court on whether the recent decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, ___ U.S. ___, 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007), applied to F5's motion to dismiss. *Tellabs* addresses inference drawing under the Private Securities Litigation Reform Act of 1995, an unusual statute imposing special pleading requirements for securities fraud class actions. That statute, however, "does not apply to individual or derivative suits." *Romero v. Career Educ. Corp.*, No. Civ.A. 793-N, 2005 WL 1798042, at *3 (Del. Ch. July 19, 2005). Accordingly, *Tellabs* has no bearing here.

Although *Ryan* was decided only last year, it already has a long line of followers precisely because it is well reasoned. Other Delaware Court of Chancery decisions involving options backdating follow *Ryan*. *See Conrad*, 940 A.2d at 39-40; *Weiss*, 948 A.2d at 440-48; *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 592 n.74 (Del. Ch. 2007). Federal judges in Washington, applying Delaware law, have also relied on *Ryan*. Recently, for example, Judge Robart "adopt[ed] the reasoning in *Ryan* and finds that [plaintiff] alleged facts sufficient to reasonably infer that backdating rather than innocent bookkeeping errors occurred." *Edmonds*, 524 F. Supp. 2d at 1276. Federal courts outside this state follow *Ryan* too.[10] Even when distinguishing *Ryan*, other federal judges refer to this seminal precedent with approval.[11]

Tellingly, F5 identifies only one decision supposedly at odds with *Ryan*. According to F5, *Ryan* was somehow rejected in *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007). To the contrary, the *Desimone* court

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10 *See, e.g.*, *Affymetrix*, 2008 U.S. Dist. LEXIS 86187, at *16-*25; *In re Cirrus Logic, Inc.*, No. A-07-CA-212-SS, 2008 WL 4065925, at *5 (W.D. Tex. Aug. 28, 2008); *In re Atmel Corp. Derivative Litig.*, C 06-4592 JF (HRL), 2008 WL 2561957, at *5-*8 (N.D. Cal. June 25, 2008); *In re Maxim Integrated Prods., Inc., Derivative Litig.*, 574 F. Supp. 2d 1046, 1060-61 (N.D. Cal. 2008); *Plymouth County Ret. Ass'n v. Schroeder*, No. 07-CV-04772 ADS ETB, 2008 WL 4254151, at *4-*9 (E.D.N.Y. Sept. 5, 2008); *Belova v. Sharp*, No. CV 07-299-MO, 2008 WL 700961, at *4-*6 (D. Or. Mar. 13, 2008).

11 *See In re VeriSign, Inc., Derivative Litig.*, 531 F. Supp. 2d 1173, 1193 (N.D. Cal. 2007); *In re Finisar Corp.*, 542 F. Supp. 2d 980, 990-93 (N.D. Cal. 2008).

lauded *Ryan* as "carefully-reasoned" and "well-written" but distinguished its facts. *Id.* at 929-31.

Similar to *Ryan*, plaintiffs here employed the Merrill Lynch methodology. It reveals that, between 1999 and 2006, the F5 defendants received, on average, a 788.6 percent return on their stock option grants while shareholders received, on average, only a 19.9 percent return over the same time period – a mammoth disparity of 768.7 percent in favor of management. PA:23. Plaintiffs have also alleged that of the 26 grants issued during the relevant period, 9 fell on the date with the lowest closing price in the month while another 3 fell on the second-lowest price date in the month. PA:25. Similar to *Ryan*, F5's shareholder-approved stock option plans expressly disallow backdating. PA:17-20. Just as in *Ryan*, moreover, plaintiffs have alleged that defendants made false public disclosures and, as a result, have subjected F5 to liability for accounting, disclosure, and tax consequences. PA:38-60. While plaintiffs in *Ryan* alleged that "three members of a [six-member] board approved backdated options, and another board member accepted them," *Ryan*, 918 A.2d at 356, plaintiffs have done one better. The operative complaint alleges that four members of the six-member board not just approved, but received, backdated options. PA:64-66. Long delays in reporting option grants to the SEC further support the reasonable inference that many grants were backdated. PA:24.

Thus, while F5 seeks to recast the complaint as relying exclusively on the Merrill Lynch study, plaintiffs do not rest entirely on statistical analysis. Their complaint is much broader and deeper. Statistics and probabilities, and other facts, corroborate what F5 essentially admitted in its bombshell to the market that accounting and related financial statements for several years "should no longer be relied upon." PA:4. Contrary to F5's suggestion, demand futility in this case does not rest on "the conclusory allegation that a director 'approved' a challenged option grant," and *Ryan* did not hold this will somehow suffice. OB49. As in *Ryan*, plaintiffs have pleaded diverse and particularized facts supporting the reasonable inference that backdating occurred, thereby excusing demand.

For its part, F5 urges a grudging pleading standard akin to proving the case with smoking guns before any discovery. As support for this stringent approach, F5 has relied previously on *In re CNET Networks, Inc.*, 483 F. Supp. 2d 947 (N.D. Cal. 2007), which purports to apply Delaware law. Briefly, however, *CNET* runs afoul of *Ryan* and has been rejected by the Delaware Chancery Court for this reason.

In *CNET*, a federal court in California refused to find demand excused where plaintiffs alleged eight specific option grants between 1998 and 2003 were backdated, but failed to plead facts about when and how often all past stock options were granted, under what circumstances those options were granted, or the board's role in granting the allegedly backdated options. *Id.* at 958-59. Defendants there even admitted backdating occurred. *Id.* at 950-51. Nevertheless, the court analyzed each stock option grant in detail, drawing inferences against the plaintiffs to determine whether there could be an innocent explanation for the grant dates. After concluding that only one of the grants could reasonably have been backdated and imputed to the current board, the court then considered whether there was reason to doubt any of the directors could be disinterested or independent. Although two directors served on the compensation committee at the time of the challenged conduct, the court noted that their "mere membership" did not alone suffice to show they were conflicted. *Id.* at 963.

The *CNET* decision strays from the pleading principles followed by *Ryan* and the many courts in its line. *CNET* placed an improper burden on the plaintiffs there when the court seemingly allowed defendants, on a motion to dismiss, to rebut allegations of backdating. Under *CNET*, a derivative plaintiff would need to refute any countervailing argument or inference potentially favoring the defense. Again, at this stage, plaintiffs must only allege facts from which backdating may be reasonably inferred. *See, e.g.*, *Ryan*, 918 A.2d at 355 n.34; *Edmonds*, 524 F. Supp. 2d at 1274.

Indeed, on where Delaware stands, *Ryan* is unquestionably the law. The Chancery Court has explicitly disapproved of *CNET*:

> To the extent *CNET* andseveral other recent decisions of that court [the U.S. District Court for the Northern District of California] can be read as applying a substantially harsher standard than is applied in *Ryan* or in this decision, the court declines to follow them.

Conrad, 940 A.2d at 38 n.22. As *Conrad* and many other courts have concluded, *Ryan* strikes an appropriate balance on what derivative plaintiffs in options backdating cases must plead to show demand was futile. The principles animating *Ryan* and its progeny ensure shareholder access to the judicial system to remedy serious corporate misconduct without opening floodgates for baseless claims.

IV. CONCLUSION

To summarize plaintiffs' position, the answer to the certified question is that a presuit demand will be excused under RCW 23B.07.400(2) when it would be futile or useless. Because Delaware's guidance is persuasive in elaborating Washington law, this Court should follow the *Aronson* two-part test for assessing demand futility in derivative litigation generally, and *Ryan* in derivative cases involving options backdating.

DATED: November 14, 2008 Respectfully submitted,

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DECLARATION OF SERVICE BY MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interested party in the within action; that declarant's business address is 655 West Broadway, Suite 1900, San Diego, California 92101.

2. That on November 14, 2008, declarant served the **PLAINTIFFS' BRIEF ON CERTIFIED QUESTION** by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this fourteenth day of November, 2008, at San Diego, California.

Terree DeVries

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